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ABSTRACT

This paper responds to a congressional request for more information concerning first, the potential cost savings from direct rather than guaranteed student loans and second, the ability of the Department of Education and postsecondary institutions to effectively manage a direct lending program. The report: (1) provides a more complete analysis of the potential savings under a direct loan approach, (2) explains how direct loans achieve cost savings, and (3) presents the results of focus group interviews that were conducted with financial aid administrators and school business officers from selected postsecondary education institutions to gauge their receptivity to direct lending. The report indicates that a direct loan program could achieve savings to the federal government within the first 5 years of $4.8 billion, enabling the government to partially offset program costs with borrowers' interest payments, reducing the cost of the interest benefit, and eliminating special allowance payments. The focus group discussions showed mixed views regarding institutions' ability to manage direct loan programs. Participants base this lack of confidence on factors ranging from time needed for the management of other programs to an apparent lack of interest in direct lending. Appendices include details of the study methodology, an analysis of statistical assumptions, a rationale for the focus group methodology, cost saving comparisons from the use of direct lending and a list of major contributors to the report. (GLR)

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United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on Postsecondary Education, Committee on Education and Labor, House of Representatives

November 1992

STUDENT LOANS

Direct Loans Could Save Billions in First 5 Years With Proper Implementation

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GAO/HRD-93-27

GAO

United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-249663

November 25, 1992

The Honorable William D. Ford
Chairman, Subcommittee on
Postsecondary Education
Committee on Education and Labor
House of Representatives

Dear Mr. Chairman:

We previously reported that the federal government could save from $620 million to $1.5 billion annually by using direct rather than guaranteed loans to provide loan assistance to postsecondary students.[1] Subsequently, in reauthorizing the Higher Education Act of 1965, the Congress established a demonstration project to test the direct loan concept beginning in July 1994.

Because our previous analysis did not consider some federal expenditures associated with direct lending, such as the start-up costs, we noted that the results needed to be viewed with caution. Furthermore, while the prospect of cost savings generated widespread enthusiasm, some policymakers expressed doubt about the abilities of the Department of Education and postsecondary institutions to effectively manage the administrative responsibilities associated with direct lending. At your request, we conducted this follow-up study, which (1) contains a more complete analysis of the potential savings under a direct loan approach, (2) explains how direct loans achieve cost savings, and (3) presents the results of focus group interviews that we conducted with financial aid administrators and school business officers from selected postsecondary education institutions to gauge their receptivity to direct lending.

Background

The main source of federal assistance for postsecondary students is the Federal Family Educational Loan Program (formerly the Stafford Student Loan Program)—about $13.5 billion in loans were made to over 3 million students in fiscal year 1991. The program's delivery system is complex and multilayered, involving 5 kinds of loans, more than 7,500 educational institutions, about 7,800 commercial lenders, 35 secondary marketers, and 46 state or nonprofit agencies.[2] Students typically apply through their

[1]Student Loans: Direct Loans Could Save Money and Simplify Program Administration (GAO/HRD-91-144BR, Sept. 27, 1991).

[2]The Stafford Student Loan Program consisted of four separate guaranteed loans: Stafford loans, Parent Loans for Undergraduate Students (PLUS), Supplemental Loans for Students (SLS), and consolidated loans.

school to receive a guaranteed student loan from a commercial bank or other lender, who may hold the loan throughout its lifetime or sell it to a secondary market purchaser. The note holder is responsible for servicing and collecting on the loan. Each state establishes or designates a guaranty agency to guarantee student loans under its jurisdiction. Guaranty agencies insure lenders against default and are in turn reinsured by the Department of Education. Guaranty agencies also monitor school and lender compliance with program rules.

High Costs and Lack of Accountability Spurred the Search for an Alternative

The need to restrain costs has been a principal reason for pursuing alternatives to guaranteed student loans. The Stafford program's cost to the federal government consists primarily of default claims and interest subsidies. Education reimburses guaranty agencies for 100 percent of default claims, unless defaults rise above specified levels in a given year. These reimbursements more than doubled to $3.2 billion between fiscal years 1987 and 1991. The program's interest subsidies take two forms. The first is called the "interest benefit"—interest payments made by Education on behalf of the students while they attend school. The second is called the "special allowance"—incentive payments made by Education to lenders throughout the life of the loan to raise their interest revenue to competitive levels. Interest subsidy costs have been highly volatile; for example, special allowance costs nearly tripled between fiscal years 1987 and 1990.

Concern about the financial integrity of guaranteed student loan programs has also contributed to the interest in alternative approaches. Both we and Education's Office of Inspector General have identified substantial accountability problems related to Education's management of these programs. For example, in April 1991 we found Education's Student Loan Insurance Fund unauditable (GAO/AFMD-91-53ML). In addition, in March 1991 the Office of Inspector General and the Office of Management and Budget completed a study that found that Education's poor management practices contribute to high default rates, fraud, and abuse in the guaranteed student loan programs.

Advocates see direct loans as an opportunity to simplify the loan process and reduce costs by eliminating several financial intermediaries. Direct lending would obviate the need for commercial lenders, guaranty agencies, and secondary markets. The Department of the Treasury would raise loan capital by issuing securities. Postsecondary institutions would act as agents for Education and use federal funds to make loans to qualifying

students. Education would service and collect the loans, presumably by contracting with private firms.

Results in Brief

A switch to direct student loans could save the federal government about $4.8 billion—in present value terms—within the first 5 years of implementation.[3] Adjusted to reflect loan repayments, direct loans could cost about $9.7 billion as opposed to $14.6 billion for guaranteed loans over this period. A direct loan program could achieve these savings by enabling the government to partially offset program costs with borrowers' interest payments, reducing the cost of the interest benefit, and eliminating special allowance payments.

Our focus group participants' views were mixed regarding their ability to administer a direct loan program, but clearly negative regarding Education's ability to manage it. Generally, participants confident in their ability to manage direct lending (1) expressed satisfaction with the performance of program lenders and guaranty agencies, (2) gained experience in administering direct lending through the Perkins Loan Program, or (3) had sophisticated infrastructures (especially staff and computer resources) supporting their student loan operations.[4] The reverse conditions generally prevailed for those participants who expressed misgivings about being able to administer direct lending. Participants based their lack of confidence in Education's ability to manage the program on factors ranging from its management of other programs to its apparent lack of interest in direct lending.

Scope and Methodology

Our earlier comparative cost analysis of guaranteed and direct student loans focused on a 1-year cohort of Stafford loans—the largest of the four guaranteed student loan programs. For this report, we provided a more comprehensive examination of the implications of direct lending by

[3]Unless otherwise stated, the dollar values we cite throughout this report are expressed in present values as of October 1993.

[4]About 3,000 of 8,000 schools in the Stafford Program also participate in the Perkins Loan Program. These schools use a combination of federal and school capital in a revolving loan fund to make low-interest rate student loans. These schools also originate loans and collect loan payments. The Perkins Program is much smaller than the Stafford Program—about $860 million in loan volume for fiscal year 1991.

- expanding the cost comparison to include the SLS and PLUS programs;
- extending the analysis period to compare costs for loans made over a 5-year period (fiscal years 1994-98);[5]
- estimating federal administrative costs for guaranteed and direct loans;
- incorporating estimates of the start-up costs associated with a direct loan program;
- updating our economic assumptions and refining our computer simulation; and
- conducting focus group interviews with financial aid administrators and business officers from judgmentally selected postsecondary education institutions.

Appendixes I and II contain a detailed explanation of the assumptions that underlie our baseline cost estimates and the results of our sensitivity analysis on certain assumptions, such as future interest rates. Appendix III details our objective, scope, and methodology with regard to focus groups and discusses the limitations involved in reporting the results of these groups. Briefly stated, the purpose of our focus groups was to elicit discussion and identify issues, and the results are not necessarily representative of postsecondary institutions as a whole. Appendix IV contains the summary description of a direct student loan program we used to elicit discussion from our focus group participants.

Direct Student Loans Could Save Billions of Dollars

Substituting direct for guaranteed student loans could save the federal government about $4.8 billion for loans made in fiscal years 1994-98 (see table 1). Interest earnings from direct loans would allow the government to partially offset its cost of subsidizing students' interest expenses and supplying loan capital. The expected reductions in these costs would more than compensate for the government's start-up and higher administrative costs associated with direct lending. Because Education projects Stafford loans to remain the largest program component, replacing them with direct loans makes up the greatest proportion of expected savings—over $3 billion.

[5]We use the phrase "loans made" throughout this report as a substitute for the more technically correct term "loan commitments." The initial disbursement of some loans occurs during the year after the loan commitment.

Table 1: Comparison of Federal Costs Under Guaranteed and Direct Student Loan Programs[a]

Present value (millions)

	Cost of student loan program using		
Category	**Guaranteed loans**	**Direct loans**	**Difference**
Program costs net of receipts	$14,298	$9,229	$5,069
Start-up costs	•	54	-54
Administrative costs	253	445	-192
Net costs	**$14,551**	**$9,728**	**$4,823**

[a]Appendix V contains an expanded version of this table along with brief descriptions of the cost categories.

Interest Margin on Direct Loans Opens the Gateway for Cost Savings

The federal government could use interest earnings from direct student loans to curtail program costs. Unlike the case with guaranteed student loans, direct lending would mean the federal government—not commercial lenders—would receive students' interest payments. During repayment periods, the federal government could earn more from borrowers' interest than the interest it pays on debt securities. This difference is commonly referred to as a net interest margin. Based on the Congressional Budget Office's (CBO's) interest rate forecast, the government could realize about $25.3 billion in interest earnings and incur about $18.9 billion in interest expenses for direct loans made in fiscal years 1994-98—resulting in a net interest margin of about $6.4 billion. The government could use these proceeds to partially offset program costs.

Direct student loans could also substantially reduce the cost of providing the interest benefit. For Stafford loans, Education makes interest payments to lenders on students' behalf as long as they attend school at least half-time and during statutory loan deferment and grace periods. Most Stafford loans carry an 8-percent interest rate during these periods. Given this rate, the interest benefit could cost Education about $7.24 billion for loans made during fiscal years 1994-98. By comparison, in a direct loan program the cost of the interest benefit would equal the government's cost of borrowing, which is expected to be below 8 percent. We assumed the cost of funds for each loan cohort would equal the interest rate on 10-year Treasury notes as forecast by CBO—7.1 percent. At this rate, we expect the interest benefit to cost about $6.43 billion, or $815 million less for the 5-year period.

Direct student loans would eliminate the other main interest subsidy—special allowance payments to lenders. To ensure an adequate stock of loan capital, lenders of guaranteed student loans receive the special allowance from Education in addition to borrowers' interest payments. For most loans, this subsidy is set equal to the bond equivalent yield on 91-day Treasury bills plus an additional interest supplement of 3.25 percent. If the borrower's interest rate is below this guaranteed yield, Education pays the difference. For loans made in fiscal years 1994-98, Education could make about $2.11 billion in special allowance payments. Special allowance payments would not be needed under a direct loan program.

Lower Program Cost Would Outweigh Start-Up and Higher Administrative Costs

One-time start-up costs and increases in administrative costs would lessen but not offset the federal cost savings expected from a switch to direct student loans. The government's start-up costs would consist of expenses necessary to develop a direct loan program's infrastructure—such as expenses for procuring and developing computer support systems and for hiring and training oversight personnel—and could total about $54 million. Administrative costs for direct lending would mostly entail salary expenses for Education staff and could total about $445 million—about $192 million more than the administrative expense associated with guaranteed loans. The higher administrative costs under direct lending reflect, in part, the increased oversight responsibilities for postsecondary institutions' and servicers' performance expected of Education. These two factors could reduce the cost savings expected through the first year of implementation by $170 million—from about $980 million to $810 million. Thereafter, a direct loan program could save over $1 billion in each of the following 4 years, for an overall savings of about $4.8 billion. Appendix VI illustrates our baseline estimate of the annual and cumulative cost savings expected from direct loans.

Savings Mostly Derived From Stafford Loans

Most of the savings expected from direct lending would come from Stafford loans. These loans could account for about $3.2 billion, or roughly two-thirds, of total savings. The savings associated from SLS and PLUS could total about $1.1 billion and $500 million, respectively. This distribution reflects Education's projection that Stafford loans will comprise about 74 percent of the guaranteed student loans made in fiscal years 1994-98. Similarly, Education expects SLS and PLUS to comprise about 17 and 10 percent, respectively, of these loans. Appendix VII depicts our cost savings estimate by loan type.

Focus Groups Express Concerns About Direct Loan Administration

Both financial aid administrators and business officers in our focus groups were divided over the advisability of switching to a direct loan program. Many of their concerns centered on whether such a program could be efficiently administered, particularly at the national level. Participants also suggested several ways to increase the likelihood of a successful direct loan program.

Some Characteristics of Those Confident of Their Ability to Manage Direct Lending

Participants who spoke optimistically about their ability to administer a direct loan program generally (1) expressed frustration with the numerous intermediaries under the current program, (2) administered the Perkins Loan Program, or (3) represented schools that had adequate computer systems to help manage relatively large loan volumes.

Poor Relations With Intermediaries

Some participants believed that eliminating commercial lenders and guaranty agencies would ensure that students receive correct and consistent information about their loan obligations. They said students are often confused by interacting with multiple entities because they frequently receive conflicting information. For example, when secondary marketers purchase student loans, the promissory note holder and loan servicer often change several times. This confuses students about where they should send payments and who processes their deferments. Some participants said that they would be glad to eliminate all the miscommunication between the schools and these intermediaries. Participants often cited the need to return checks to lenders for cancellation after students fail to enroll for the required courses each school session as a very labor-intensive task.

Experience as Perkins Lenders

Many participants had gained confidence through years of handling a wide range of loan processing and servicing tasks, such as preparing and executing promissory notes, maintaining loan records, safeguarding loan documents, and collecting loan payments. They expressed little reservation about accepting the liability for processing loan documents since they already handle these functions. They envisioned direct lending being easier to administer than the Perkins Program since the school would not be responsible for loan servicing or collection, which they considered the most troublesome and time-consuming tasks.

Adequate Infrastructures

Participants from schools that have computerized processes and sufficiently trained staff believed that they could implement the program with a minimal increase in their workload. These participants anticipated making only a few changes in the way they report loan information, track

borrowers, or reconcile loan balances, since these processes are already established and computerized.

Some Characteristics of Those Concerned About Their Ability to Manage Direct Lending

Participants who voiced concern about their ability to manage a direct loan program generally (1) believed that the current loan delivery system worked reasonably well, (2) represented schools that had no expertise in administering Perkins, or (3) relied on limited computer resources or manual systems to manage relatively small loan volumes. Although these participants cited some dissatisfaction with the Stafford program, most were reluctant to endorse an untested program.

Effective Relations With Intermediaries

These participants said they rely on lenders and guaranty agencies to support their operation and carry out their responsibilities. They said lenders and guaranty agencies give timely answers to inquiries, provide brochures, and assist in borrower entrance and exit interviews. They also viewed these intermediaries as powerful partners in lobbying Education or the Congress to change onerous program requirements. Many business officers believed that the current delivery system worked relatively well in making funds available to the students quickly, sometimes within a few days. They questioned whether Education could match their success in this critical area.

No Experience With Perkins

Some participants said they would have difficulty administering direct lending because they lack experience in handling lender responsibilities. They were concerned about being liable for a variety of problems, such as making loan origination errors, losing promissory notes and other key documents, and giving incorrect or incomplete loan disclosure information.

Inadequate Infrastructures

Participants from schools that had fewer staff and computer resources were also reluctant to go along with direct lending. These participants felt that imposing more responsibility on their limited staff and other resources would increase error rates and result in some task not being performed at all. One participant from a proprietary school with about 500 students and 200 loans said she and a part-time clerk make up the entire financial aid office and cannot handle any additional work. Another participant, from a school with about an enrollment of about 150, said that she maintains financial aid information on index cards in a box.

Education Receives "No Confidence Vote"

The majority of participants expressed little or no confidence in Education's ability to manage a direct loan program. Specifically, these participants said that they do not believe Education can either efficiently distribute loan proceeds or effectively contract with private agencies for servicing and collecting loans. In justifying their negative opinion, many participants cited several problems, including burdensome regulations, unrealistic program goals, broken commitments, unanswered inquiries, unfair program audits, and misinformation. Many cited the Education Secretary's public opposition to the direct loan proposal as evidence of Education's unwillingness to provide effective leadership for such a program. Many participants said that if Education fails to meet its administrative commitments, the costs will be borne by schools, which will have to absorb Education's responsibilities, and by students, who could receive less financial aid.

Suggested Features for Implementation

Many participants offered suggestions on ways to increase the likelihood of successfully implementing a direct loan program. Most cited standardizing and simplifying all student aid forms as a high priority. Currently, lenders and guaranty agencies use many processes unique to their operations. Other participants felt a direct loan program should adopt proven and successful features used in other student aid programs—for example, the electronic transfer of funds used to disburse Pell grant funds to schools. Many participants believe that loan availability would not be a problem if Education used this mechanism to allocate direct loan awards. Many participants felt a reliable and accurate national student financial aid database is an indispensable requirement for success. They felt that, among other things, Education needs the database to avoid making excess awards or granting loans to ineligible borrowers.

Conclusions

The potential for savings under a direct student loan program is substantial—roughly one of every three dollars the federal government would spend providing guaranteed loans to postsecondary students. Though eliminating special allowance payments and reducing the cost of the interest benefit contributes to these savings, most of the cost savings is derived through the net interest margin generated from borrowers' interest payments.

However, if the views of student aid administrators and business officers who participated in our focus groups are indicative of the views of others, realizing the potential savings will require substantial effort on both schools and the federal government's part. For direct lending to succeed, Education will need to forge an effective partnership with postsecondary educational institutions and provide strong program leadership. Poor management by Education, for example, could trigger more loan defaults, which could substantially erode any potential cost savings. To help minimize the administrative burden that institutions could incur from direct lending, it is appropriate for Education, as it designs the pilot program, to consider the suggestions raised by our focus groups.

Agency Comments

We did not obtain written agency comments on this report, but did furnish a draft to officials at the Department of Education and the Student Loan Marketing Association (Sallie Mae) to obtain their views. In concurring with our findings and conclusions, Education did not suggest any changes. Although Sallie Mae cited several concerns about our financial analysis, we focused our response on those—the impact of the 1992 Higher Education Amendments and our use of multiple data sources—that we had not addressed in completing our previous report.

Higher Education Amendments of 1992

Sallie Mae expressed concern that our report did not reflect changes the 1992 amendments made in the Higher Education Act of 1965. We started and completed our cost analysis before the act was reauthorized and amended in 1992. Consequently, our analysis reflects the program features and policies of guaranteed student loan programs that existed before the 1992 amendments. While some changes have occurred, the programs remain basically the same. As such, the conclusions drawn from this study transfer directly to the new programs.

To measure the impact of the 1992 amendments on our baseline cost estimates, we substituted values into our simulation model to reflect the major program changes—such as the new student interest rate charges, revised eligibility criteria, and lower special allowance factor. Incorporating these changes trimmed our baseline savings estimate by about $100 million—from $4.8 billion to $4.7 billion. Table VIII.1 illustrates the distinct and aggregate impact that some major program changes had on our baseline savings estimate.

Multiple Data Sources

Sallie Mae also disagreed with our reliance on several sources to construct our cost estimates. We employed a situational process to select sources from which to develop the various cost components used in our financial analysis. For example, given commercial lenders' considerable expertise in originating loans, we found them to be the best source for loan origination costs. Similarly, because Sallie Mae is the largest holder and servicer of student loans, we believe that its servicing costs provided the best reference for approximating the compensation private contractors will require for servicing direct student loans.

We conducted this review between October 1991 and August 1992 in accordance with generally accepted government auditing standards.

Copies of the report are being sent to the Secretary of Education, congressional committees, and other interested parties. Please call me on (202) 512-7014 if you or your staff have any questions about this report. Other major contributors are listed in appendix IX.

Sincerely yours,

Linda G. Morra

Linda G. Morra
Director, Education
and Employment Issues

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Abbreviations

CBO	Congressional Budget Office
CPI	consumer price index
PLUS	Parent Loans for Undergraduate Students
SLS	Supplemental Loans for Students
T-bill	Treasury bill
SAP	special allowance payment

Objective, Scope, and Methodology for Comparative Cost Analysis

Objective and Scope

Our objective was to estimate and compare the cost of a federal student loan program using guaranteed and direct student loans. For our analysis period, we selected fiscal year 1994 as the base year and estimated the costs for loans made over 5 years—fiscal years 1994-98. Our analysis pertained to costs directly incurred by the federal government, such as administrative, program, and start-up costs. Costs outside the scope of our work included those accruing to state, local, and private institutions. Our estimates reflect costs associated with the Stafford, SLS, and PLUS, but not consolidated, loans.

Methodology

We designed a computer simulation model to calculate the present value of the federal government's costs of administering five cohorts of either guaranteed or direct student loans. We discounted the expected income stream from these loan cohorts back to the beginning of fiscal year 1994. For each loan cohort, the model estimated quarterly costs based on monthly amortization of loans entering repayment in up to 7 different years. Repayment on the these cohorts would conclude in fiscal year 2014. In converting costs to present values, we used CBO's forecast of interest rates. The Federal Credit Reform Act of 1990 does not require discounting of administrative costs for budgeting purposes. However, we transformed our administrative cost estimates into present values because we believe that the proper treatment of these costs, which accrue over time, requires us to recognize the time value of money through discounting. Also, to determine how sensitive the model's results were to changes in assumptions, we changed the values of key assumptions individually and recalculated our cost estimates (see app. II for more on our sensitivity analysis).

Assumptions Underlying Cost Estimates

The following sections contain brief descriptions of the assumptions we used to conduct our analysis.

Loan Terms

We assumed that the loan terms in effect as of mid-1992 for the Stafford Program would remain in effect throughout our analysis period. For example, we assumed that Stafford borrowers would pay (1) an origination fee of 5 percent, (2) an average insurance premium of 1.6 percent, and (3) an interest rate charge of 8 percent during the first 4 years of repayment, capped at 10 percent thereafter. If after the 4th year of repayment, 3.25 percent plus the average bond equivalent yield on 91-day Treasury bills (T-bills) is less than 10 percent, we assumed Stafford

borrowers would receive credit for the difference at the end of each calendar year.

Loan Volumes

Our assumptions regarding future loan volumes, defaults, and collections were based largely on projections and information that the Department of Education used in developing its fiscal year 1993 budget.

Special Allowance Payments

In calculating the special allowance payment (SAP), we assumed that the rate applicable for new loans in 1992 would remain unchanged. For loans financed from taxable sources, the SAP is set equal to the bond equivalent yield on 91-day T-bills plus 3.25 percent, less the borrower's interest rate. Special allowance payments for loans financed with tax-exempt debt are one-half the difference between 3.5 percent above the 91-day T-bill rate and the borrower's interest rate, with an interest rate floor of 9.5 percent. For example, when the T-bill rate is 5.5 percent and borrowers' interest rate is 8 percent, the SAP is 0.75 (5.5 percent plus 3.25 percent less 8 percent) and 1.5 percent (9.5 percent less 8 percent) for taxable and tax-exempt financed loans, respectively.

Loan Default Rates

In the absence of empirical research that suggests otherwise, we assumed identical default rates for both programs. However, due to the timing of outlays, the present value of default costs is greater under the direct loan program. Under direct lending, Education would incur costs on defaults when loans first become delinquent. In contrast, with guaranteed loans, guaranty agencies cannot request reinsurance payments on defaulted loans from Education until at least 270 days after the first missed payment. This lag causes a lower present value. Additionally, under guaranteed loan programs, on average, Education's reinsurance payments to guaranty agencies cover 98.7 percent of default claims. Under direct loans, the government would incur 100 percent of default costs. We also assumed that loans entering repayment early are more likely to default than those entering later. Finally, for loans that eventually default, we assumed that 70 percent will become delinquent in the first year of repayment and 30 percent in the second.

Future Interest Rates

Our analysis relied on CBO's January 1992 forecasts of 91-day and 52-week T-bill rates and 10-year Treasury rates. The bond equivalent yield on 91-day T-bills affects Education's special allowance payments to lenders and the effective interest rate paid by Stafford loan borrowers after the 4th year of repayment. CBO forecast 91-day T-bill rates ranging from 5.2 to 5.6 percent during fiscal years 1994-97. We assumed that the rate would remain at 5.6 percent thereafter. The bond equivalent yields on 52-week

T-bills affect borrowers' interest payments on SLS and PLUS loans. For 52-week T-bills, CBO forecast rates ranging from 5.3 to 5.7 percent during fiscal years 1994-97. Again, we assumed that the rate after fiscal year 1997 would remain at 5.7 percent. We used CBO's forecast of 10-year Treasury notes—7.1 percent—as the discount rate in our present value calculations.

Inflation Rates

We assumed that loan origination, loan servicing, and federal administrative costs would increase at rates equal to changes in the urban consumer price index (CPI) as forecast by CBO. CBO forecast an annual CPI increase of 3.6 percent for fiscal years 1994-97. We assumed that inflation would remain at 3.6 percent in later years.

Loan Servicing Costs

We assumed that Education would contract with third parties for servicing and collecting loans. Given the large loan volumes, Education should be in a position to negotiate for servicing by efficient loan servicers. As such, we assumed loan servicing costs would approximate the levels experienced by the nation's more efficient servicers, such as the Student Loan Marketing Association. Adjusting its reported costs for inflation, changes in the average loan amount, overhead, profit, and risk, we estimated that loan servicing would cost about 1 percent of loans outstanding per year.

Loan Origination Costs

Loan origination functions now performed by lenders would become the responsibility of postsecondary institutions under a direct loan program. The Consumer Bankers Association in 1989 surveyed its member banks concerning their loan origination costs. Our $35-per-loan estimate is a result of adjusting for inflation the average annual loan origination cost reported by the 24 respondents to the survey question.

Start-Up Costs

We developed our start-up cost estimates by analyzing Education's October 1991 direct loan cost projections. These start-up costs consist of federal administrative costs that Education would incur in fiscal year 1993, before implementation, including computer systems, program review staff, and trainers.

Administrative Costs

To estimate federal administrative costs for guaranteed loans, we adjusted the estimates Education reported in its fiscal year 1993 budget. We estimated federal administrative costs for direct loans using Education's October 1991 direct loan cost projections for fiscal year 1997—the first year of implementation in Education's analysis. Adjusting these estimates for inflation, we projected administrative costs for each fiscal year through 2014. We developed a method for allocating these costs proportionally and

discounted the estimated administrative costs for the loans made in fiscal years 1994 through 1998 to determine their present value.

Sensitivity Analysis

The values we assumed for certain key variables strongly influenced our estimate of the savings achievable from direct lending. These values were based on forecasts of financial indicators and other costs through the year 2014. Since several of our baseline assumptions relied on forecasts of future economic conditions, we expect some divergence between our assumptions and the circumstances that ultimately prevail. To see how alternative assumptions would modify our savings estimate, we conducted sensitivity analysis by individually substituting other values for some of the more critical assumptions. As table II.1 shows, our savings estimate was particularly sensitive to assumptions we made about future interest rates, loan servicing costs, and inflation.

Table II.1: Sensitivity of Direct Loan Savings Estimate for Loans Made in Fiscal Years 1994-98 (Present Value)

Assumption	Baseline value	Change in baseline value	Increase or decrease in savings due to alternative assumption (millions)
Discount rate	7.1%	+0.5%	–$1,740
		–0.5%	$1,849
T-bill rates:			
91-day	5.2-5.6%	+0.5%	$1,581
52-week	5.3-5.7%	–0.5%	–$1,530
Loan servicing costs as percent of loans outstanding	1.0%	+0.5%	–$1,952
		–0.5%	$1,952
Loan origination costs per loan	$35	+$10	–$247
		–$10	$247
Annual inflation of servicing, origination, and federal administrative costs	3.6%	+0.5%	–$1,037
		–0.5%	$828
Average Stafford loan amount:			
Fiscal year 1994	$2,914	+10%	$695
Fiscal year 1998	$3,155	–10%	–$695

Future Interest Rates

Our savings estimate was extremely sensitive to the assumed discount rate, which we used to approximate the government's average cost of borrowing capital to supply student loans in a direct program. The savings estimate varied inversely with changes to the baseline discount rate assumption. A higher discount rate increases the government's cost of

funds and reduces the present value of students' interest payments and other receipts. Increasing the discount rate 0.5 percentage points above CBO's projected yield of 7.1 percent decreased expected savings to about $3.1 billion. Conversely, a lower discount rate decreases the government's cost of funds and increases the present value of its receipts. Decreasing the discount rate 0.5 percentage points below CBO's forecast yield increased expected savings to about $6.7 billion.

The values we assumed for future T-bill yields also heavily influenced our savings estimate. Higher T-bill yields—to which special allowance payments are tied—increased the cost of a guaranteed loan program, thereby increasing the expected savings. Alternatively, lower T-bill rates ease the burden of special allowance payments, which, in turn, diminishes expected savings from direct lending. Using T-bill rates 0.5 percentage points higher than the baseline assumptions increased expected savings to $6.4 billion; using T-bill rates 0.5 percentage points lower reduced expected savings to $3.3 billion.

Loan Servicing and Origination Costs

The values we assumed for future loan servicing costs exerted the strongest influence on our savings estimate. Assumptions on loan origination costs, however, had the least. In varying loan servicing costs, reducing Education's compensation to private contractors by 0.5 percentage points below our baseline assumption increased our savings estimate to about $6.8 billion. Increasing Education's compensation by a commensurate rate reduced the savings estimate to about $2.9 billion. For loan origination costs, raising our baseline estimate $10 per loan reduced the savings estimate to $4.6 billion, while lowering it $10 increased savings to $5.1 billion.

Inflation

Our inflation assumptions are reflected in our estimates of loan servicing, origination, and federal administrative costs. Raising the inflation assumption 0.5 percentage points above the baseline—from 3.6 to 4.1 percent annually—reduced expected savings to about $3.8 billion. In contrast, lowering inflation an equivalent degree increased expected savings to about $5.7 billion.

Average Loan Size

The average size of student loans has a strong influence on our savings estimate. Increasing the average amount loaned (Stafford, SLS, and PLUS)—while holding the number of loans constant—by 10 percent

increased estimated savings to about $5.8 billion. Similarly, decreasing the average amount loaned by the same rate decreased the savings estimate to $3.8 billion.

Other Assumptions

A marginally lower savings estimate would result from a smaller special allowance factor, higher default rates, or a larger portion of loans affected by required minimum monthly loan payments.

- Lowering the special allowance factor from 3.25 to 3.1 percent reduced estimated savings to $4.5 billion.
- Raising default rates for Stafford loans from about 19—the level forecast by Education for 1994 and after—to 25 percent lowered estimated savings to $4.6 billion.
- Increasing the proportion of borrowers affected by the $50 minimum monthly payment from about 27 to 37 percent decreased estimated savings to $4.7 billion. On the other hand, eliminating the minimum payment requirement increased our savings estimate to $5.1 billion.[1]

[1]This requirement shortens the repayment period of loans made for less than $4,121. This in turn reduces both the total interest borrowers would pay Education under a direct lending and the special allowance payments Education would pay lenders of guaranteed loans.

Objective, Scope, and Methodology for Using Focus Groups

Objective

We used focus group interviews to obtain the opinions and insights of postsecondary school officials on the acceptability and impact of replacing guaranteed student loan programs with a direct loan program. In conducting the focus groups, we were interested in both the range of concerns and the potential support that might be expressed.

Focus group interviews are a form of qualitative research in which a specially trained leader, the moderator, meets with a small group of people who have similar characteristics and are knowledgeable about the specific issue. Although the discussions are informal, the moderator encourages participants to share their thoughts and experiences on specific topics.

Scope

We held our focus groups in Los Angeles and Chicago because of the large number and variety of schools in and around these two cities. The Los Angeles groups represented schools in southern California. The Chicago participants represented schools in Illinois, Indiana, Michigan, Ohio, and Wisconsin.

We conducted eight focus groups—four in the Los Angeles area and four in the Chicago area. Groups had from 6 to 10 participants. We used a screening process to select participants and thereby ensure that school officials most knowledgeable about the student loans would participate. We divided the groups according to two factors: (1) whether the school currently participated in the Perkins Student Loan Program, and (2) whether the participant was a financial aid officer or a business officer (see table III.1).

Table III.1: Composition Matrix of Focus Groups

	Perkins	Non-Perkins
Financial aid officers	3 groups	3 groups
Business officers	1 group	1 group

In selecting participants, we wanted to incorporate a variety of school sizes and types. The groups included participants from 4-year public and private schools, 2-year public and private schools, and proprietary schools from the six states.

Methodology

A trained GAO focus group moderator led the focus group discussions while an assistant moderator took notes. We developed a focus group guide to assist the moderator in leading the discussions. We also audio- and video-taped each focus group session to facilitate analysis and report writing.

The moderator began each focus group by describing the purpose of our study and explaining how focus groups work. The participants were presented with a brief summary of a direct lending proposal (see app. IV) and then asked open-ended questions on such topics as:

- potential effects on recordkeeping/reporting requirements,
- problems resulting from the transfer of liability for loans to schools,
- transition from the current program to direct lending, and
- effects on school workloads and accompanying burdens.

Participants were asked questions about what would happen if the proposed legislation was enacted. Responses to such questions were, of necessity, speculative. Nevertheless, the "speculations" of many group participants showed a great deal of consensus. This consistency in recurring themes provides some validation.

Use of Focus Group Results

The focus group approach provides qualitative information on the attitudes, perceptions, and beliefs of a small group of individuals in order to develop insight into a particular area. The results are descriptive, showing the range of opinions and ideas among participants. However, the results cannot serve as a basis for statistical inference because focus groups are not designed to (1) demonstrate the extent of a problem or to generalize results to a larger population, (2) develop a consensus for an agreed-upon plan of action, or (3) provide statistically representative samples with reliable quantitative estimates.

The composition of the groups was intended to assure some representation of different sizes and types of schools, both involved and not involved in the Perkins Loan Program. While the groups consisted of knowledgeable professionals, they were not intended to represent a random sampling of school officials.

Summary of the Direct Student Loan Proposal Used in Conducting the Focus Groups

The following is a brief summary of a direct lending proposal that GAO's moderator presented to each focus group participant before each session. The proposal closely resembled the direct student loan proposal contained in the House bill for reauthorizing the Higher Education Act (H.R. 3553).

- The direct loan program would operate without lenders, guaranty agencies, or secondary market purchasers. The federal government would provide capital to participating schools, which would either originate loans or make arrangements with third parties to originate loans to their students. Treasury would sell government securities to meet the capital requirements of direct lending.
- Institutions would apply annually to the Department of Education for funding based on the estimated financial needs of their students. On behalf of the government, institutions would determine student and parent eligibility, prepare promissory notes, and allocate loan funds to students following procedures similar to those used in the Perkins Loan Program. Education would disburse funds to the institution by July 1 for the academic year. Beginning July 1, 1994, 500 schools could participate in the program. Another 1,000 schools could participate in the 1995-96 academic year, and all institutions would participate in 1996-97.
- Education would operate the servicing aspects of the program through competitive private sector contracts, including a contract for management of the national direct loan data system, servicing, collection, and loan consolidation. Education would offer students income-contingent, graduated, and conventional repayment plans. Each institution would transmit signed promissory notes to assigned contractors, which would be responsible for servicing and collecting direct loans.
- Like the Stafford Student Loan Program, direct loans would be funded as an entitlement, with no limit on the amount of capital available; student and parent eligibility would determine capital requirements. Direct loans would carry interest rates similar to those charged under the Stafford Program. Neither a student origination fee nor an insurance premium would be charged. Institutions would be provided a $20-per-loan administrative fee each year.

Line Item Comparison of GAO's Estimated Federal Costs for Guaranteed and Direct Student Loan Programs

Table V.1 displays a line item comparison of our cost estimates of guaranteed and direct student loan programs. We expressed these costs in 1994 present value terms for loans made in fiscal years 1994-98. Positive figures represent federal payments; negative figures represent federal receipts. Following the table is a brief discussion of the outlays and receipts shown.

Table V.1: Comparison of Federal Costs for Guaranteed and Direct Student Loan Programs for Loans Made in Fiscal Years 1994-98

Present value in millions

Program outlays and receipts	Guaranteed loans	Direct loans
Cost of funds	•	$18,911
Borrowers' interest payments	•	-$25,321
Interest benefits	$7,243	$6,428
Special allowance payments	$2,105	•
Net default	$7,038	$8,242
Servicing and loan origination costs	•	$4,769
Administrative cost allowance (to guaranty agencies) less reinsurance fees	$519	•
Insurance premiums	•	-$1,149
Origination fees	-$2,606	-$2,651
Federal administrative costs	$253	$445
Start-up costs	•	$54
Present value of net federal costs	**$14,551[a]**	**$9,728**

[a]The sum of items shown does not equal the total due to rounding.

Cost of Funds

Interest payments for federal securities used to provide student loan capital. With respect to Stafford loans, these costs only pertain to loans in repayment; interest accruing before this period is shown as interest benefit cost.

Borrowers' Interest Payments

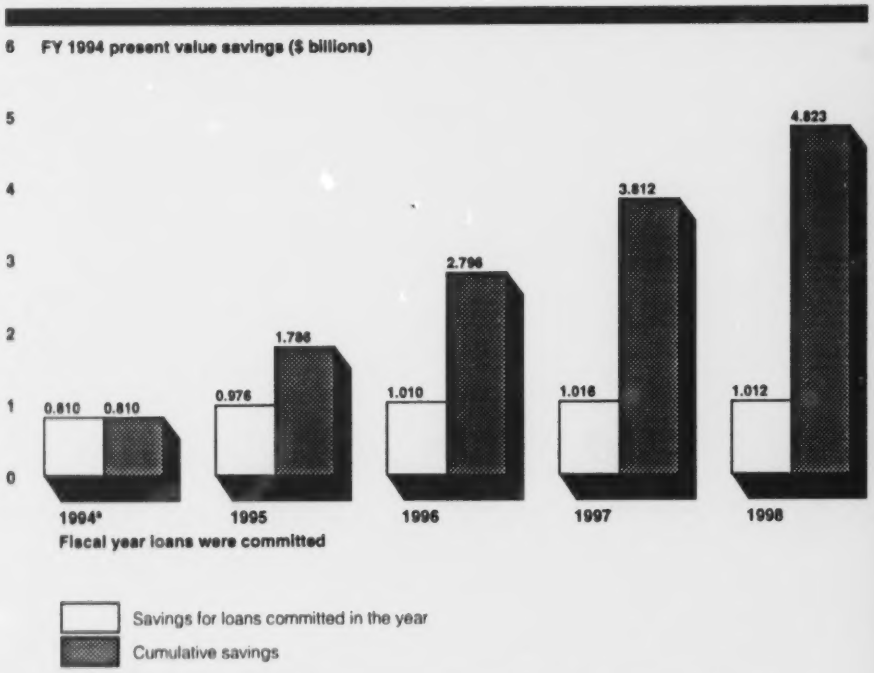
Amounts owed by students before adjustments for defaults, death, disability, and bankruptcy. This also includes capitalized interest for SLS loans.

Interest Benefits (Applicable to Stafford Loans Only)

In the guaranteed loan program, payment of accrued interest made by Education on behalf of students while they attend school. In a direct loan program, federal borrowing costs for the same period. Interest benefits are

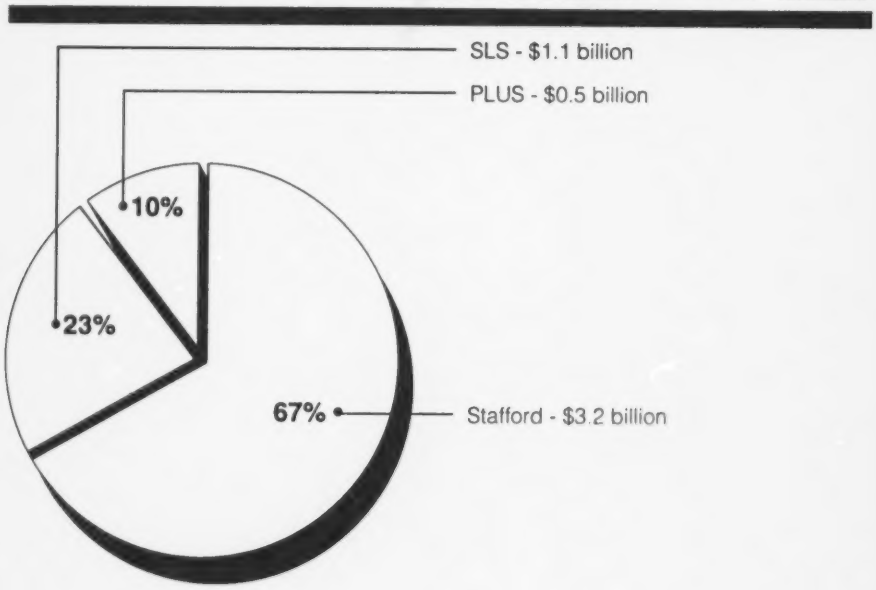
	lower for direct loans because the estimated federal cost of borrowing is less than students' interest rate.
Special Allowance Payments	Quarterly subsidy payments to lenders of guaranteed student loans—eliminated with direct lending.
Net Default	Default costs after adjustments for collections and related costs. Although we assumed the same default rate for both programs, the federal cost of defaults is higher in a direct loan program because (1) outlays would occur earlier and (2) in guaranteed loan programs, guaranty agencies sometimes absorb a portion of default costs.
Servicing and Loan Origination Costs	Primarily borne by the note holder of guaranteed loans, incurred by Education under a direct loan program.
Administrative Cost Allowance	Quarterly payments, net of reinsurance fees, made to guaranty agencies as reimbursement for their administrative expenses—eliminated with direct lending.
Insurance Premiums	Fees for insuring loans against losses, now received by guaranty agencies, would become federal receipts with direct lending.
Origination Fees	A fee charged to borrowers to help defray program costs. In a direct loan program the present value is somewhat higher because Education would collect them sooner by deducting them before loan disbursement.
Federal Administrative Costs	Include Education's costs for computer systems, training, and program review staff.
Start-Up Costs	Include Education's fiscal year 1993 costs for computer systems development, training, and program oversight staff.

Annual and Cumulative Cost Savings From a Direct Loan Program



[a]The figure for fiscal year 1994 includes estimated fiscal year 1993 start-up costs of about $54 million for the direct loan program.

Cost Savings by Type of Loan for Fiscal Years 1994-98



Appendix VIII

Effect of the Higher Education Amendments of 1992 on GAO's Baseline Savings Estimate

We based our comparative cost analysis on the Stafford Student Loan Program as it existed before the Higher Education Amendments of 1992. Besides renaming the program the Federal Family Education Loan Program, the amendments changed some of the loan terms and conditions for Stafford, PLUS, and SLS loans. The aggregate effect of these changes on our baseline cost estimates was minimal, reducing our estimate of the savings potential of direct loans from $4.8 billion to about $4.7 billion. Table VIII.1 shows the individual and combined effects of these provisions on our baseline savings estimate for loans made in the fiscal year 1994-98 period.

Table VIII.1: Estimated Effects of 1992 Higher Education Act Amendments[a]

	GAO's baseline assumption	Effect of Higher Education Amendments of 1992	Increase or decrease in GAO's baseline savings (millions)
Special allowance payment factor	3.25%	3.10%	-$293
Origination fees	5% fee for Stafford loans	5% fee for Stafford, SLS, and PLUS loans	0
Student interest rates on Stafford loans	8% for 4 years of repayment, then 10% with adjustments for payments above 3.25% over 91- day T-bill yield	3.1% above the 91-day T- bill yield capped at 9%	-591
Student interest rates on SLS and PLUS loans	3.25% above 52-week T-bills yield capped at 12%	3.1% above the T-bill yield capped at 11% percent for SLS and 10% for PLUS	-137
Average Stafford loan amounts[bc]	Average Stafford loan: FY 1994, $2,914 FY 1998, $3,155	Average Stafford loan: FY 1994, $3,371 FY 1998, $3,831	361
	Number of Stafford loans: FY 1994, 4.0 million FY 1998, 4.5 million	Number of Stafford loans: FY 1994, 5.9 million FY 1998, 6.9 million	646
Net effect on GAO's baseline savings estimate[d]			-108

[a]Present value of savings for loans made in fiscal years 1994-98.

[b]These revised loan estimates reflect changes made by the Higher Education Amendments as well as other changes.

[c]The table shows average loan amounts and loan volume for Stafford as an example, but the change in our baseline estimate also reflects revised estimates for the SLS and PLUS programs.

[d]The combined effect differs from the sum of the individual effects due to interaction between simultaneous changes.

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Related GAO Products

Stafford Student Loans: Prompt Payment of Origination Fees Could Reduce Costs (GAO/HRD-92-61, July 24, 1992).

Guaranteed Student Loans: Eliminating Interest Rate Floors Could Generate Substantial Savings (GAO/HRD-92-113, July 21, 1992).

Stafford Student Loans: Lower Subsidy Payments Could Achieve Savings Without Affecting Access (GAO/HRD-92-7, Jan. 6, 1992).

Direct Student Loans Could Save Money and Simplify Program Administration (GAO/T-HRD-92-8, Oct. 29, 1991).

Student Loans: Direct Loans Could Save Money and Simplify Program Administration (GAO/HRD-91-144BR, Sept. 27, 1991).

Vulnerabilities in the Stafford Student Loan Program (GAO/T-HRD-91-33, May 29, 1991).

Management Letter (GAO/AFMD-91-53ML, April 1991).

Guaranteed Student Loans: Profits of Secondary Market Lenders Vary Widely (GAO/HRD-90-130BR, Sept. 28, 1990).

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